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DIRECTORATE OF
INTELLIGENCE

Intelligence Memorandum

*Canada: Balance-of-Payments Developments
Since the Smithsonian Agreement*

On file Department of Commerce release
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CANADA:
Balance-of-Payments Developments
Since the Smithsonian Agreement

The US trade deficit with Canada did not narrow last year, because our economic upswing spurred imports and the Canadian dollar remained basically undervalued. As usual, large interest and dividend receipts sufficed to put the US current account in the black, however. Labor cost differentials and pressing raw materials requirements attracted substantial US funds into Canadian manufacturing and mining; these flows plus the provincial governments' borrowing across the border greatly increased the US basic balance deficit to about US \$1 billion. The United States ended the year with a small bilateral payments surplus only because of a sudden, huge increase in short-term capital inflows arising from a switch in interest rate differentials.

Accelerating Canadian consumer spending and improved price competitiveness for American goods generated an impressive 18% rise in US exports. Our own high economic growth rate caused imports to increase almost as fast, however, and the US trade deficit held steady at \$1.1 billion – about one-fourth of the global US deficit. One result of the Canadians' buying spree was a slackening growth of Canadian automotive exports and a large gain in automotive imports. The US deficit in automotive products trade practically disappeared, whereas \$194 million in deficits were incurred in both 1970 and 1971.

Canada's trade surplus with countries other than the United States fell sharply last year because imports increased greatly while export gains were held back by Western Europe's economic slowdown. Greatly increased capital inflows more than offset the current account deterioration, however, and Canada's overall payments balance with these countries improved. The Smithsonian changes did not appreciably affect Canadian trade with countries other than the United States, largely because exporters to Canada in the revaluing countries absorbed about half of the revaluations.

Although another large gain in Canadian automobile purchases probably will further improve the US balance in bilateral automotive trade, little if any change in the overall trade deficit with Canada can be expected this year if US economic growth slightly surpasses the Canadian rate, as seems likely. The US basic balance with Canada probably will worsen a little because bullish Canadian business conditions promise to boost US capital exports. Greatly increased imports from countries other than the United States are expected to reduce Canada's global basic balance, however.

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DISCUSSION

Pre-Smithsonian Trends

1. During the 1960s, natural opportunities for exchange of various US manufactures for Canadian petroleum, metals, forest products, and certain industrial items brought rapid expansion in both countries' bilateral trade. Aided by inflows of US capital and soaring motor vehicle sales following the 1965 Automotive Products Agreement, Canada's bilateral basic balance shifted from a large deficit to a large surplus.¹ Export growth slackened in 1970-71 as motor vehicle sales became less exuberant, but import growth slowed even more, pushing Canada's newly emerged bilateral trade surplus to a record \$1.1 billion. Ottawa's curbs on provincial government borrowing abroad reduced capital inflows, however, and narrowed the bilateral basic balance surplus to nearly \$600 million in 1971. High Canadian interest rates that generated a substantial net inflow of short-term capital in 1971, in sharp contrast to the usual outflow, pushed Canada's bilateral payments surplus to an impressive \$1.3 billion.

2. Because of strong worldwide demand for minerals, grain, and various manufactured goods, Canada's exports to countries other than the United States also have done well. The trade surplus with these countries since 1965 has generally amounted to about \$1 billion annually. Because of exceptionally large sales in 1970, the trade surplus quadrupled, but economic slowdowns in Japan and Western Europe helped to cut it to \$1.2 billion in 1971. The unusually large exports and short-term capital inflows in 1970 induced Ottawa to float the Canadian dollar on 31 May 1970, and good export performance allowed it to appreciate by 8% within 18 months. The overall balance of payments remained strong, however, and Canada's foreign reserves rose to \$5.6 billion at the end of 1971, compared with \$4.7 billion a year earlier.

Canada at the Smithsonian Conference

3. Trudeau's representative went to the Smithsonian conference determined to continue the controlled float under which Ottawa was holding the Canadian dollar close to parity with the US dollar. In view of the currency's appreciation, the other conference participants apparently raised no objections to the arrangement even though Canada was heading for another large trade surplus. Indeed, the revaluations of the British, French, and Italian currencies (in terms of the US dollar) essentially offset the

1. The data in this memorandum are drawn from Canadian sources which typically show major differences from US statistics. According to US sources, the basic balance deficit with Canada amounted to \$1.5 billion in 1972. For a discussion of the differences between US and Canadian statistics, see Appendix A.

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Canadian dollar's earlier appreciation against them, and the revaluation of the West German and Japanese currencies boosted their value about 5% and 8%, respectively, above the pre-float rates. Thus the Smithsonian participants appeared to accept Ottawa's view that the Canadian currency was no longer undervalued compared with the US dollar but was overvalued compared with the Japanese and certain West European currencies.

Balance of Payments with the United States in 1972

Trade Trends

4. Despite more rapid economic growth in the United States than in Canada last year, the US bilateral trade deficit continued at the 1971 level of \$1.1 billion. A cyclical upswing in Canadian consumer spending for housing, automobiles, and other durable goods pushed imports to almost \$13 billion – an 18% rise (see Table 1). Pacing the rise were imports of

Table 1

Canada: Balance of Payments with the United States¹

	Million US \$			
	1969	1970	1971	1972 Provisional
Trade balance	311	997	1,134	1,110
Exports (f.o.b.)	9,678	10,403	12,004	13,885
Imports (f.o.b.)	9,367	9,406	10,870	12,775
Balance on services and transfers	-1,122	-1,159	-1,295	-1,420
Of which:				
Interest and dividends	-817	-929	-1,029	-937
Travel	63	140	185	107
Current account balance	-811	-162	-161	-310
Balance on long-term capital account	1,540	780	728	1,315
Of which:				
Net direct investment	256	323	422	432
Transactions in Canadian securities	1,013	463	137	352
Basic balance	729	618	567	1,005
Balance on short-term capital account (including errors and omissions)	-429	35	780	-1,327
Payments surplus (+) or deficit (-)	300	653	1,347	-322

1. These statistics are from Canadian sources. For conversion rates and a discussion of discrepancies between US and Canadian data, see Appendix A.

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construction materials and consumer goods – up 28% and 23%, respectively. Within the category of machinery and equipment, particularly large increases were registered for farm and construction equipment. The increase in purchases of motor vehicles and parts simply paralleled that of total imports, as shown in the following tabulation:

	<u>Million US \$</u>		
	1971	1972	Percentage Increase
Total¹	10,942	12,918	18
Construction materials	270	345	28
Consumer goods	1,260	1,552	23
Of which:			
Durables	473	597	26
Machinery and equipment	2,885	3,438	19
Motor vehicles and parts	3,925	4,619	18
Industrial materials	2,237	2,544	14
Fuels and lubricants	238	263	11
Other	127	157	24

1. Minor differences between these totals and those shown in Table 1 reflect adjustments in the latter for balance-of-payments purposes.

Instrumental in stimulating imports from the United States was the appreciation of Canada's currency in 1970-71 and the United States' good record in restricting export price increases in 1970-72, which combined to reduce the ratio of import prices to domestic Canadian prices by about 5% since 1969 (see Figure 1).

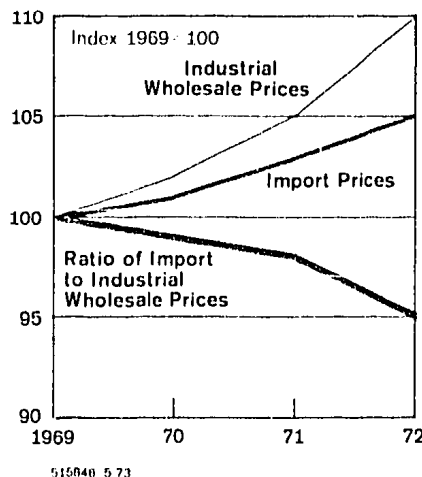
5. Sparked by accelerated US economic growth, Canada's bilateral exports rose by an impressive 16%, to \$13.9 billion. Because Canadian exporters had already passed on the currency appreciation in the form of higher US dollar prices the year before, most of the 1972 export gain represented increased volume. The appreciation did not prevent good export volume in 1972, because many sales are governed by long-term contracts, large volumes of goods are produced specifically for export to the United States by US subsidiaries, export prices of other US trading partners rose much more, and US domestic prices also increased, as shown in the following tabulation:

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	Percentage Increase		
	1970	1971	First Half 1972
Canadian exports to the United States			
Value in US dollars	8	15	17
Volume	6	6	13
Export prices in US dollars	2	8	4
Export prices of other countries in US dollars			
Japan	6	3	13
West Germany	10	6	13
United Kingdom	7	10	16
US wholesale prices	4	3	4

6. Exports to the United States would have risen considerably more if the growth in sales of automotive products had not slowed markedly. A buying spree among Canadian consumers - which raised domestic sales of motor vehicles by 13% - held export growth to 12% as well as swelling automotive imports. Automotive export sales also were hampered by General Motors' start-up problems on the production run of its 1973 models and by Ford's difficulties in meeting the requirements for US anti-pollution certification. Canada ended the year with a surplus of only \$6 million in the bilateral automotive trade, compared with \$194 million in 1971 (see Figure 2).

Canada:
Trends in Import Prices
and Domestic Prices



7. US demand for Canadian raw materials generally strengthened in 1972. Petroleum and natural gas sales jumped by 28%. Although wood pulp sales slipped as US demand dropped, forest products as a group did very well, gaining 19% (see Table 2). About one-third of the rise represented price increases growing out of a shortage of softwood logs. Indeed, this

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price gain accounted for most of the 1972 rise in Canadian prices for exports to the United States.

8. Paced by aircraft products and machinery, sales of manufactured goods other than automotive products increased 15% in 1972, compared with a 4% rise in 1971. Moreover, increased volume accounted for nearly all of the 1972 rise. Roughly half of these exports consist of sophisticated electronic and other products made by subsidiaries of US companies. Despite the gain, greatly increased Canadian imports of US manufactures – particularly consumer goods – increased Canada's bilateral deficit in manufactured goods (excluding automotive products) from \$1.9 billion in 1971 to an estimated \$2.2 billion in 1972.

Figure 2

**Canada:
Automotive Products Trade
with the US**

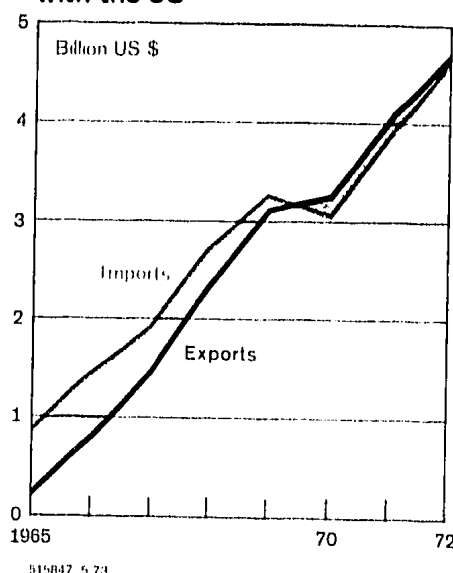


Table 2

Canada: Composition of Exports to the United States

	Million US \$			
	1969	1970	1971	1972
Total ¹	9,818	10,458	12,006	13,887
Automotive products	3,182	3,242	4,119	4,625
Of which:				
Automobiles and chassis	1,586	1,579	2,003	2,103
Trucks	472	460	475	509
Snowmobiles	111	151	139	116
Automobile parts	857	981	1,495	1,800
Other manufactured goods	1,960	2,159	2,246	2,592
Of which:				
Aircraft and parts	225	229	218	313
Chemicals and fertilizers	251	301	349	382
Petroleum and natural gas	649	819	1,038	1,325
Of which:				
Crude oil	486	622	787	1,008
Metals and other minerals	1,403	1,630	1,646	1,769
Of which:				
Copper-nickel	319	444	434	472
Aluminum	210	176	233	247
Forest products	2,029	1,928	2,260	2,687
Of which:				
Softwood lumber	488	418	656	987
Newsprint	851	836	880	934
Agricultural products	400	476	476	529
Other	195	204	221	360

1. Differences between these totals and those shown in Table 1 reflect adjustments in the latter for balance-of-payments purposes.

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Capital Flows

9. Canada remained a favored area for US investment, especially in manufacturing and mining. Net inflows of long-term capital jumped to \$1.3 billion in 1972, an 80% gain that helped to push the basic balance surplus to \$1.0 billion. Net sales of Canadian securities nearly tripled as the provincial governments sold many new issues abroad. These sales were induced by a tightened domestic capital market and occurred despite Ottawa's efforts to discourage them. Net direct investments by US firms slipped about 10% during the year but the drop was much more than offset by a fall-off in Canadian investments in the United States.

10. Short-term capital movements between the two countries exhibited large swings in response to small interest rate differentials. Canada's higher rates prompted substantial short-term inflows in the first five months, but the differential began to reverse in June. As a result, Canada had a \$1.3 billion net outflow to the United States for the year, reverting for the first time since 1969 to its traditional position as an exporter of short-term funds. The outflow ended Canada's role in recent years as a "pass through" for US short-term funds destined for Europe, the amount of which totaled about \$720 million in 1971. It also gave Canada a bilateral payments deficit in excess of \$300 million.

Trade and Payments with Other Countries in 1972

11. Canada's trade surplus with its other trading partners fell sharply last year because imports climbed a remarkable 24% and exports did poorly (see Table 3). The import rise reflected increased demand for such goods as Japanese automobiles and electronic equipment. Although the Smithsonian agreement revalued these countries' currencies an average of 10% against the Canadian dollar, exporters to Canada apparently absorbed about half of the revaluation because volume gains accounted for 80% of the import rise. The 1972 import gain continued the recent inroads by these countries -- particularly Japan -- in the Canadian market, cutting the US share from 72% in 1969 to 69% last year. Exports rose by only 4% owing to Western Europe's economic slowdown.

12. Greatly increased capital inflows more than offset the current account deterioration, however, and Canada finished the year with a substantial overall payments surplus with these countries. As a result, Canadian foreign reserves rose by \$480 million (including about \$260 million arising from the International Monetary Fund's new issue for Special Drawing Rights and from gold revaluation) to \$6.0 billion. (For statistics on Canada's global balance of payments, see Appendix B.)

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Table 3

**Canada: Balance of Payments with Countries
Other Than the United States**

	Million US \$			
	1969	1970	1971	1972 Provisional
Trade balance	453	1,786	1,169	276
Exports (f.o.b.)	4,042	5,644	5,826	6,052
Imports (f.o.b.)	3,589	3,858	4,657	5,776
Balance on services and transfers	-522	-632	-611	-550
Current account balance	-69	1,154	558	-274
Balance on long-term capital account	618	-69	-334	458
Of which:				
Net direct investment	68	194	158	-137
Transactions in Canadian securities	563	7	-17	1,152
Basic balance	549	1,085	224	184
Balance on short-term capital account ¹	-788	-273	-794	354
Payments surplus (+) or deficit (-)	-239	812	-570	538

1. Including errors and omissions.

Outlook for 1973

13. Contrary to earlier expectations, Canada's basic balance surplus with the United States now seems likely to increase only moderately rather than sharply this year. Although net long-term capital inflows will rise, another large import increase probably will hold the trade surplus at approximately last year's level. Since the government is following a moderately expansionary policy to combat unemployment, the outlook is for real economic growth of 6%-6-1/2%, a strong rise in consumer spending, and little progress in reducing the present 5% inflation rate. In these circumstances, imports could well rise something like last year's 17-1/2% - and possibly a little more than that if a proposed five percentage-point cut in food and other consumer good import duties is enacted, as seems likely.

14. Although US economic growth has accelerated, the increase in Canadian exports probably will only match last year's rapid pace. An expected slackening in US housing starts may cut Canadian lumber sales, and even if US demand holds up well, shipments of forest products to the United States may be curbed by greatly increased Japanese demand for softwood logs. Booming domestic sales probably will worsen Canada's bilateral balance in automotive products trade. The growth of crude oil

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exports also could slow, as shipments are approaching pipeline capacity. But manufactured goods exports probably will gain substantially and -- aided by firming world prices -- sales of other mineral products promise to do well. All in all, 1973 exports to the United States seem likely to expand by last year's 16%, holding Canada's bilateral trade surplus at about the 1972 level if imports grow by 17-1/2%. Because of an expected sizable gain in interest and dividend remittances, Canada's current account deficit could rise to some \$500 million.

15. Resource development projects requiring large amounts of foreign portfolio capital, such as the James Bay hydroelectric project, are still mostly in preliminary stages. But infrastructure needed for rapidly growing population will cause the provincial governments to seek considerable long-term capital abroad. US long-term interest rates probably will remain below those in Western Europe; thus, more of these funds probably will be sought in the United States this year. The favorable business outlook in both countries points to a continuing high level of US direct investment. Although the Canadian government has proposed somewhat stronger legislation to screen foreign investments than that which died in Parliament last year, the measure is still too mild to disturb US companies. Moreover, Ottawa recently announced that foreign investments will continue to be encouraged through subsidies and other financial incentives. The share of new manufacturing capacity intended for production for the US market will be somewhat smaller than in the late 1960s, however, since the currency float has cut the earlier Canadian-US wage gap by about one-half.

16. Little, if any, US investment in Canadian automotive production capacity seems likely in 1973. Even if Canada's automotive exports lag behind imports, US manufacturers in Canada will still meet by a comfortable margin the "safeguard" requirements of the value-added and production-to-sales ratios specified in the Automotive Products Agreement. If the "safeguards" are retained, however, continuing rapid growth of motor vehicle sales in Canada probably will force the companies to expand their Canadian capacity substantially within the next three years or so.

17. Accelerating economic growth and replenishment of shrunken inventories in Japan and Western Europe presage a substantial increase in Canada's exports to other countries this year. Imports from them probably will expand even more, however, and Canada's small trade surplus with countries other than the United States is likely to swing to a small deficit. The prospective decline in Canada's global basic balance surplus and continuation of net short-term capital outflows should continue to ease the upward pressure of 1971 and the first half of 1972 on the Canadian dollar and thus facilitate a fairly clean float at approximate parity with the US dollar.

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Prospects for the Longer Term

18. Contrary to earlier forecasts, Canada's trade surplus with the United States seems likely to level off or decline in 1974-75 if the countries' economic growth rates approximate 5-1/2%-6%, as seems likely. Exports promise to expand strongly despite sluggish automotive products sales and slackening growth of manufactured goods shipments as US manufacturing investments slow. In a previous study,² we forecast a Canadian bilateral export growth of 9% to 12% annually during the period 1973-75. While Canada's improved competitive position in the US market since last February's revaluation of Japanese and West European currencies could push the rate above that range, Canadian purchases will grow at least as rapidly -- and probably faster, especially if import prices rise less than domestic prices. Each percentage point by which import growth exceeds export growth in the two-year period will shave approximately \$100 million off Canada's bilateral trade surplus.

19. Although long-term capital inflows through 1975 are expected to increase Canada's bilateral basic balance surplus, the prospective trade trends will make Canada a tough negotiator in talks with the United States. Ottawa will strongly resist making substantial concessions on the major bilateral trade issues -- for example, the "safeguard" provisions of the bilateral Automotive Agreement, Canadian purchases of military equipment, or Canadian subsidies for direct foreign investment. Progress in reducing US-Canadian trade frictions therefore is likely to be slow and difficult.

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APPENDIX A

STATISTICAL NOTE

US dollar values shown in this memorandum were obtained by converting Canadian data at the rates of US \$0.925 per Canadian dollar for 1969 and US \$0.958 per Canadian dollar for 1970. Because Canada's currency fluctuated only between US \$0.99 and US \$1.02 during 1971-72, data for those years were converted on a dollar-for-dollar basis.

Persistently large discrepancies between US and Canadian data attest to extensive errors and differences in accounting procedures. These discrepancies occur mainly in data on bilateral exports, imports, and long-term capital flows. Although the discrepancies cause large differences in the countries' calculations of size of bilateral balances, they generally have not caused major differences in the indicated year-to-year changes in trade and other transactions.

To reconcile discrepancies in bilateral trade statistics, the US-Canadian Trade Statistics Committee was established in 1971. According to the committee's first report, which covers only trade statistics for 1970, the import values calculated by each country were inflated by sizable over-valuations of some goods in the customs declarations. Errors also were found in the countries' export statistics - for example, the inclusion in US data of goods shipped to Canada for temporary storage before re-export to third countries and the over-valuation of some transactions. The committee's work resulted in an agreed figure for the US trade deficit of \$1.4 billion for 1970, compared with the originally published Canadian figure of \$1.0 billion and the US figure of \$2.0 billion (\$1.7 billion after the customary adjustments for balance-of-payments purposes). The original and revised statistics on the trade flows are shown in Table A-1.

More recently, Statistics Canada and the US Bureau of Economic Analysis have extended these corrections to cover other current account transactions in 1970. The agreed results show a US current account deficit with Canada of \$100 million, in contrast to the \$600 million deficit previously reported by the United States and the \$160 million US surplus reported by Canada (as shown in Table 1). The \$260 million increase in Canadian current account receipts was the net result of corrections increasing the trade surplus, reducing freight receipts, and increasing other service payments and unilateral transfers.

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Table A-1

US-Canadian Trade: Comparison of Original and Revised Statistics

	Million US \$					
	Northbound		Southbound		US Trade Deficit	
	US Data	Canadian Data	US Data	Canadian Data	US Data	Canadian Data
Published trade statistics ¹	9,084	9,486	11,092	10,522	-2,008	-1,036
US data adjusted for balance-of-payments purposes ²	9,044	10,720	-1,676
Reconciled data	9,148		10,572		-1,424	

1. US customs data as shown in Highlights of Exports and Imports, published by the US Bureau of the Census. Minor differences in Canadian data, as shown above, and in Table 2 probably are due to the use of different conversion factors.

2. US data as in the Survey of Current Business published by the US Bureau of Economic Analysis. Canada publishes only one set of trade statistics, which is adjusted for balance-of-payments purposes.

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	Million US \$			
	1969	1970	1971	1972 Provisional
Trade balance	764	2,783	2,303	1,386
Exports (f.o.b.)	13,720	16,047	17,830	19,937
Imports (f.o.b.)	12,956	13,264	15,527	18,551
Balance on services and transfers	-1,644	1,791	-1,906	-1,970
Of which:				
Interest and dividends	-846	-979	-1,071	-937
Travel	-202	-216	-211	-230
Current account balance	-880	992	397	-584
Balance on long-term capital account	2,158	711	394	1,773
Of which:				
Net direct investment	324	517	580	295
Transactions in Canadian securities	1,576	470	120	1,504
Basic balance	1,278	1,703	791	1,189
Balance on short-term capital account (including errors and omissions)	-1,217	-238	-14	-973
Total	61	1,572	891	480
Additions to reserves				
From balance-of-payments transactions	61	1,465	777	216
Other (SDRs and gold revaluation)	0	107	114	264

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